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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF
UNS GAS, INC. FOR THE ESTABLISHMENT
OF JUST AND REASONABLE RATES AND
CHARGES DESIGNED TO REALIZE A
REASONABLE RATE OF RETURN ON THE
FAIR VALUE OF THE PROPERTIES OF
UNS GAS, INC. DEVOTED TO ITS
OPERATIONS THROUGHOUT THE STATE
OF ARIZONA.

Docket No. G-04204A-08-0571

RESIDENTIAL UTILITY CONSUMER OFFICE'S
("RUCO")

REPLY BRIEF

Arizona Corporation Commission

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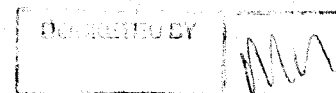


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1 The Residential Utility Consumer Office ("RUCO") hereby submits its Reply Brief on the
2 matters raised in UNS Gas, Inc.'s ("UNSG" or "Company") recent rate hearing.

3
4 **I. CONTESTED RATE BASE ISSUES**

5 **Plant-In-Service**

6 The Company misconstrues RUCO's as well as Staff's position by inferring that both
7 positions would never allow for the inclusion of non-revenue producing post test year plant in
8 rate base. Company Brief at 5. The Company goes on to list some previous Commission
9 decisions where post test year plant was allowed in rate base. Id. at 5-6. RUCO does not
10 take issue with the fact that the Commission has allowed post test year plant in rate base
11 before. RUCO acknowledges that each case has its own set of circumstances and the
12 Commission has included as well as excluded post test year plant in multitudes of cases
13 before. In fact, the Commission excluded the Company's similar request for the inclusion in
14 rate base of post test year plant in the Company's last rate case. Decision No. 70011 at 8-9.
15 The decision of whether to include post test year plant in rate base in this case is clearly within
16 the Commission's discretion. RUCO-21 at 14.

17 A closer review of the Commission's last UNS Gas decision negates the Company's
18 suggestion that the only criterion that the Commission ought to consider is whether the plant
19 in question is revenue neutral. In Decision No. 70011, the Commission concluded "Although
20 the Commission has allowed post-test-year plant in several prior cases involving water
21 companies, it appears that the issue was developed on the record in those proceedings in a
22 manner that afforded assurance that a mismatch of revenues did not occur." Decision No.
23 70011 at 8. Nonetheless, the Company interpreted the Commission's decision to only require
24 the post test year plant not produce additional revenue. See for example, Company Brief at 6.

1 Based on its loose interpretation, the Company gave verbal instructions to its personnel to
2 identify "non-additional" revenue producing plant that was not being installed for the purpose
3 of meeting customer growth and investments that would have been made whether UNSG
4 added additional customers or not. RUCO-22 at 15. UNSG attempted to identify
5 replacements for mains and services whose primary purposes were to serve existing
6 customers and would have been replaced regardless of customer additions. Id.

7 The Company's interpretation did not consider whether the projects it considered would
8 be expense neutral or whether it would help facilitate service to customers added after the test
9 year. Id. If post test year plant is revenue producing or supports the addition of customers
10 beyond the end of the test year, or if it enables the reduction of expenses, such as the
11 replacement of aging mains and services, or the replacement of older transportation of
12 equipment, then a mis-match would result. Id. Rates would be increased for the inclusion of
13 such plant in rate base; however, revenue would not be extended for new customers and
14 expense reductions would not be reflected. Id.

15 UNSG's response to RUCO's data request 11.18 identifies various post test year
16 expense reductions, including reduced overtime, reduced vehicle maintenance, reduced
17 vehicle depreciation, etc., none of which have been reflected. Id. at 16 and Attachment RCS-
18 8, page 13 of 52. It is unfair to include in rate base plant that was not in service during the test
19 year and to ignore expense reductions. Despite the Company's arguments, this is not what
20 the Commission had in mind in Decision No. 70011. Rather than attempt to make pro forma
21 adjustments for the post test year expense reductions, the Company's post test year plant
22 adjustment should be rejected. Id.

Customer Advances

The Company argues that RUCO's recommendation to reduce the rate base by the amount of the customer advances at the time the Company receives the advances is contrary to "regulatory theory". Company brief at 8. Rather, the Company argues that the reductions should not be made until the plant goes into service. In the Company's last rate case, the Commission rejected similar arguments made by the Company noting that "...advances represent customer-supplied funds that are properly deducted from the Company's rate base. Indeed, the Commission's own rules contemplated that such a deduction is required, as Staff witness Smith testified." Decision No. 70011 at 9. RUCO is at a loss to understand the regulatory theory that supports the Company's position in this case.

The Company further complains about the discriminatory effect caused by the mismatches that result from RUCO's and Staff's approach. Company Brief at 8. Again, in the Company's last rate case the Commission addressed the same complaint. "The Company's attempt to frame this issue as one in which it is being treated in a discriminatory manner is unpersuasive." Decision No. 70011 at 9. "As we have stated in prior cases, regulated utility companies control the timing of their rate case filings and should not be heard to complain when their chosen test periods do not coincide with the completion of plant that may be considered used and useful and therefore properly included in rate base. We believe our conclusions regarding UNSG's CWIP-related proposals are entirely consistent with the treatment afforded to other utility companies regulated by the Commission and provide a result that is fair to both the Company and its customers." Decision No. 70011 at 9-10. The Company has not raised any new arguments here and the Commission's sound reasoning in the last case should be applied in this case.

1 **Prepayments**

2 RUCO incorporates its position set forth in its Closing Brief¹. RUCO Brief at 7.

3 **Cash Working Capital**

4 The Company maintains that it explored all available options for obtaining supply and
5 the alternative it chose was the least costly. Company Brief at 10. The Company's argument
6 is inconsistent with the record. The Company admitted that other alternatives available to it
7 included making more frequent payments of amounts owed, the Company could have
8 provided a standby letter of credit from a financial institution, it could have curtailed doing new
9 business with the supplier, or any combination of the above. RUCO-21 at 29-30, Schedule
10 RCS-8 at page 21. Any one or combination of these alternatives to making more frequent
11 payments could have negated the impact on test year costs.

12 While Mr. Grant may have testified that other options were more costly, in spite of the
13 other options available to it and the huge cash working capital increase resulting from the
14 Company's choice, the Company failed to provide any cost-benefit analysis, that the
15 management decision to make more frequent payments was the least cost option. Indeed, it
16 appears that this may have been the greatest cost option from the perspective of ratepayers,
17 as evidenced by the huge increase in UNSG's request for a cash working capital allowance.

18 **Customer Deposits**

19 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 9 – 10.
20
21
22

23 ¹ Where RUCO's Closing Brief replies to the arguments raised in the Company's Closing Brief and RUCO has
24 nothing more to add or where the Company has not addressed an issue in its Closing Brief, RUCO will simply
incorporate the argument that it made in its Closing Brief as its reply.

1 **Accumulated Deferred Income Taxes**

2 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 10 – 11.

3
4 **II. CONTESTED OPERATING ISSUES**

5 The Company's arguments here are mostly valid. The Company argues in favor of the
6 "traditional method" because that is what the Commission approved in the last case.
7 Company Brief at 11-12. Ironically, it was the Company in the last case that argued that the
8 use of the "traditional method" is not optimal because in cases of cyclical growth the traditional
9 method breaks down and ultimately gives totally counterintuitive results. Decision No. 70011
10 at 18.

11 RUCO now finds itself in the position of arguing against the "traditional method" in this
12 case because it gives exactly what the Company claimed in its last case – counterintuitive
13 results. While the Company's arguments are valid, the Company's recommendation should
14 be rejected because the Commission never said that it was establishing a policy favoring the
15 "traditional method" in all cases. On the contrary, the Commission concluded: "... that UNS
16 has not presented a valid case for departing from the traditional method of calculating
17 customer service annualization. Although the Company's arguments have some validity in a
18 theoretical sense, adoption of the cyclical methodology is not warranted in this proceeding."
19 Decision No. 70011 at 19.

20 Circumstances have changed and RUCO and Staff have presented valid arguments
21 why the "traditional method" should be rejected in this case. During the test year, it is
22 undisputed that the Company experienced growth. UNSG-20 at 7. It is simply counterintuitive
23 to reduce test year revenues when UNSG has continued to grow throughout the test year.
24 RUCO-21 at 17. According to the Company, and RUCO agrees, "Customers should expect a

1 positive customer adjustment on a growing system." UNSG-20 at 7. The Company's
2 negative customer adjustment proposal is contrary to what the Company admits its customers
3 should expect.

4 Commissioner Bill Mundell used to say that the Commissioners are not just a bunch of
5 "bean counters." The Commissioner's should not make rote decisions to maintain
6 "consistency" when the results would be counterintuitive as the Company suggests.
7 Transcript at 435. RUCO has presented a valid case for departing from the "traditional
8 method" and the Commission should adopt RUCO's recommendation.

9
10 **Depreciation and Property Taxes for CWIP/Post Test Year Plant**

11 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 14.

12 **Incentive Compensation, Stock Based Compensation and Supplemental**
13 **Executive Retirement Plan ("SERP")**

14 The Company claims that Staff and RUCO have not argued that incentive
15 compensation is an unreasonable expense. Company Brief at 22. At least from RUCO's
16 perspective this is a true statement. RUCO does not argue that the expense itself is
17 unreasonable; RUCO argues that it is unreasonable for ratepayers to pay the full amount of
18 the expense. Ratepayers do derive a benefit from the expense. Likewise, shareholders
19 benefit from the incentive compensation plan. A 50/50 sharing of the cost provides a
20 balancing of the interests between ratepayers and shareholders. RUCO Brief at 15.

21 The Company claims that RUCO fails to address Decision No. 69663 (June 28, 2007)
22 where the Commission, in the last APS rate case allowed full recovery of the cash-based
23 incentive compensation expense for a program similar to the Company's. Company Brief at
24 22. RUCO's witness, Ralph Smith addressed the Company's argument in his surrebuttal

1 testimony. RUCO-21 at 42. In short, the Commission has decided several other cases since
2 Decision No. 69663 where it has disallowed 50% of incentive pay including the UNS Electric
3 rate case, the Company's sister utility. See Decision No. 70360 at 21(May 27, 2008),
4 Decision No. 70665, Southwest Gas December 24, 2008) at 16.

5 Like incentive compensation, RUCO and the Company propose fundamentally different
6 approaches to determining whether stock based compensation and the Company's
7 Supplemental Executive Retirement Plan ("SERP") should be recovered from customers.
8 With stock based compensation, RUCO agrees with the logic of the Commission in UNS
9 Electric (Decision No. 70360 (May 27 2008) at 22) that the expense of providing stock options
10 and other stock based compensation beyond the normal levels of compensation should be the
11 expense of the shareholder and not the ratepayer. The Commission's logic has particular
12 application in the present economy where unemployment is high and money is tight for most
13 ratepayers. Ratepayers should not be shouldering extras like stock based incentives beyond
14 what is the norm.

15 Likewise, ratepayers should not be shouldering the burden of excess retirement
16 benefits to a select group of high-ranking officers in the Company. It is remarkable that the
17 Company would even request this given the current economy. While SERP may be a
18 recurring expense for the Company, it is by no means a reasonable expense for ratepayer's to
19 have to pay. These same executives already have a regular retirement plan and any
20 retirement benefits beyond that should be funded by the Company's shareholders.

21 **American Gas Association ("AGA") Dues**

22 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 18.
23
24

Outside Legal Expense

The Company proposes an outside legal expense of \$305,984. Company Brief at 18. The Company claims that RUCO has "...reduced the Company's adjustment by two-thirds to \$88,310 leaving an amount they believe is reflective of an on-going level of outside legal expense." Company Brief at 19. The Company has misstated RUCO's recommendation. RUCO is recommending the annual amount of \$171,865 of normalized rate case expense which is an amount that is fair and reasonable under the circumstances. RUCO-21 at 61.

In RUCO's Closing Brief, RUCO explained at length its recommendation. RUCO incorporates the same arguments here. RUCO agrees with the Company that the Company's allowable legal expenses should be set at a level that reflects its actual experience. RUCO-21 at 57. But this level should not translate into a recipe for charging ratepayers prospectively for levels of legal expense based on abnormally high periods in the past. RUCO's recommendation is reasonable and fair to both ratepayers and the shareholders.

Fleet Fuel Expense

RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 21.

Rate Case Expense

RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 22-23.

Payroll Expense and Payroll Tax Expense

The Company is proposing to recover a projected 2010 pay increase. The Company relies on the most recent Southwest Gas case (Decision No. 70665) and the UNS Electric rate case (Decision No. 70360). The Company's reliance on these cases is misplaced. In both cases, the salary increases had already gone into effect and were known and measurable.

Decision No. 70360 at 17, Decision No. 70665 at 10. The salary increase in the subject case has not gone into effect and is not likely to go into effect until after this rate case is decided (1 ½ years beyond the test year). Moreover, RUCO has agreed to the inclusion of the 2009 pay increase, and given the current economy now is not the time to allow projected increases that are not know and certain. RUCO-20 at 56, RUCO-21 at 68.

Interest Synchronization

RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 23.

Property Tax Expense

RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 24-25.

Postage Expense

RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 25.

III. COST OF CAPITAL

Cost of Equity

The Company criticizes RUCO's cost of equity results for being lower than RUCO's recommendation in the Company's last case, given RUCO's admission that investors are becoming more risk adverse. Further, the Company, as well as Staff discounts the CAPM model as being unsuited for the present financial situation. Company Brief at 31, Staff Brief at 16.

It is no secret or great revelation that investors are more risk adverse in a down economy. As a result investors seek safer investments. Transcript at 770. Natural gas utilities, like UNS Gas represent a safe investment which explains why on the whole these utilities are doing relatively well. RUCO-13 at 12. RUCO's witness, William Rigsby noted that

1 Value Lines five-year projected return on common equity for Southwest Gas is currently about
2 8% whereas when he filed his testimony in this case the projection was around 9%.
3 Transcript at 774. By comparison, Mr. Rigsby's 8.6% recommendation for this Company is
4 reasonable.

5 The technical analysis that the Commission has historically followed when determining
6 cost of equity further supports Mr. Rigsby analysis and not the Company's or Staff's. Both the
7 Company and Staff want to discount heavily the CAPM results because it provides low
8 returns. Company Brief at 31, Transcript at 832. With all due respect, this makes little sense.
9 The Commission has historically relied on the CAPM as it is an economic model that factors in
10 the present state of the economy. The fact that is results in low returns now is indicative of
11 the present state of the economy and should not be discounted. The Commission has not
12 disregarded its results in good times. The CAPM is saying loud and clear that the
13 Commission should reconsider what is normal given the present state of the economy and
14 adjust its cost of equity awards accordingly.

15 **IV. FAIR VALUE RATE OF RETURN**

16 The Company claims that RUCO's approach to determining fair value rate of return
17 ("FVROR") is arbitrary and unconstitutional. Company Brief at 39. On the contrary, RUCO's
18 approach is well reasoned and supported by the facts in the record as explained in more detail
19 in RUCO's Closing Brief. See RUCO Brief at 31-32. RUCO factored into its recommendation
20 the methodologies developed and employed by the Commission since the Court of Appeals
21 issued its memorandum decision in the Chaparral City Water Case. RUCO-21 at 10. In
22 addition, RUCO also factored into its recommendation the current state of the economy. Id.
23
24

1 The Company chose to adopt the FVROR methodology approved by the Commission
2 in the Chaparral City remand order, Decision No. 70441.² Using this approach, the Company
3 is recommending a FVROR of 7.30%. Company Brief at 37. Interestingly, in its direct
4 testimony, the Company's witness on this matter, Kenton Grant, testifies "I recommend that a
5 ROR of 6.80% be applied to the FVRB, even though I believe, as discussed below, that UNS
6 Gas could justify a ROR of 7.30%." UNSG-10 at 30. Mr. Grant in his surrebuttal explains this
7 discrepancy in the Company's recommendations by noting that his FVROR recommendation
8 is not limited to a maximum value of 6.80%, and the reduction was a "voluntary" measure.
9 UNSG-14 at 32. Apparently, the reduced revenue recommendations of the other parties
10 persuaded the Company to recommend the higher FVROR. Id.

11 Nonetheless, no party disputes that the appropriate methodology for determining the
12 FVROR is within the discretion of the Commission. RUCO-21 at 6. The Arizona Court of
13 Appeals has noted that the Commission is not bound to apply the weighted average cost of
14 capital as the rate of return to be applied to the FVRB, and that the appropriate methodology
15 for determining the FVROR is within the Commission's discretion. RUCO-21 at 5. In its
16 remand order, the Commission noted that there are many methods the Commission may
17 consider in determining an appropriate FVROR. RUCO-21 at 6, Decision No. 70441 at 22.
18 The method approved by the Commission in that case, and adopted by the Company in this
19 case, is not the only method available to the Commission.

20 Finally, RUCO was guided by the same factors the Commission considered in Decision
21 No. 70441. Decision No. 70441 at 37. RUCO evaluated and weighed the following: that the
22 FVRB reflects a 50/50 weighing of OCRB and RCND; that the RCND proposed by the
23

24 ² Decision No. 70441 is currently under appeal. Arizona Court of Appeals, Docket No. 1 CA-CC 08-0002

1 Company includes inflation: that the market based models used to estimate equity are related
2 to the utility's OCRB; that the Constitution require the Commission to consider FVRB; the
3 effects of inflation; the method for determining FVRB and the guidance of the Court of
4 Appeal's in its Remand Decision. Decision No. 70441 at 37. All of these factors, when given
5 appropriate weight support RUCO's recommendation of a FVROR of 5.38%. While the
6 Company may not agree, RUCO's recommendation is not arbitrary and is constitutionally
7 sufficient.

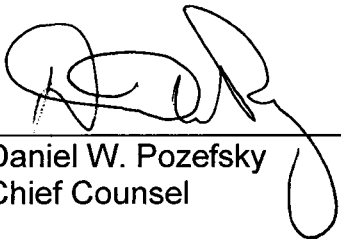
8 9 **V. RATE DESIGN**

10 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 33.

11 **CONCLUSION**

12 The Commission should increase the Company's revenue by no more than \$1.265
13 million, and adopt a rate design that will increase the customer charge from \$8.50 to \$10.00
14 per month in the rate year. The Commission should adopt RUCO's 8.61% return on equity and
15 5.38% percent FVROR.

1 RESPECTFULLY SUBMITTED this 30th day of September, 2009.

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4 
5 Daniel W. Pozefsky
Chief Counsel

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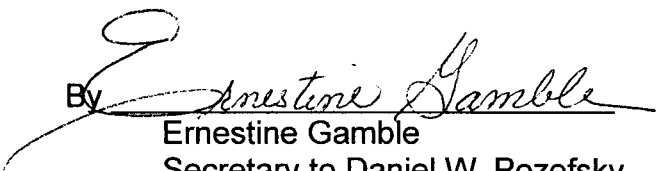
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